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Monday Morning OUTLOOK
January 5th, 2015
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2015: More Investment and Profits, Higher Rates, Dollar and Stocks

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Contrary to popular opinion, business investment is a key factor behind the current recovery. Productive investments have boosted profits to record highs and, in turn, those profits have driven stock prices to record highs. They should continue to do so.

Analysts have missed this surge in investment and profits for three reasons. First, many look at "nominal investment" – before adjustment for inflation. Second, spending on "structures" has been very weak. And, third, many analysts confuse real GDP growth with the health of corporate America.

It is true that real GDP (inflation-adjusted gross domestic product) has increased at an annual rate of just 2.3% since bottoming in Q2-2009. It is also true that nominal investment is lower today, at 12.8% of GDP, than it was in 2008 when it was 13.5% of GDP.

But, tablets and phones that cost a few hundred dollars today have capabilities that cost millions just 20 years ago. Shale oil drillers are successful on most of the wells they drill versus much lower percentages of success in the days of wildcatters. 3-D printing reduces prices, while increasing flexibility in production. Low cost apps, websites, and the cloud undermine the need for brick and mortar investment.

In other words, smaller investments are creating larger returns that are less volatile and more predictable, at least for the businesses that are generating them. Real (inflation-adjusted) business equipment spending has increased at a 9.7% annualized rate in the past 21 quarters, four times faster than real GDP, while real intellectual property spending has increased 3.5% per year. Real spending on structures is up just 0.3% annually, well below real GDP growth. New technology is reducing demand for space.

So, even though overall nominal investment has fallen as a share of GDP, after adjustment for inflation, real business investment (excluding the building of new structures) has climbed to a new, all-time, record high. Investment has boosted productivity, efficiency and profitability.

This statement clashes with relatively weak government productivity statistics, and many of those who think investment has been weak argue that there are underlying structural problems in the economy.

If you are from the left, you argue that a widening income gap and greedy, cash-hoarding corporations are keeping the economy from its full potential. If you are from the right, you argue that uncertainty in government policy is holding back progress.

But overall corporate profits suggest the exact opposite. After-tax corporate profits have almost doubled since Q4-2008, up 12.6% at an annual rate.

Profits may be the "mother's milk of prosperity," but productivity is the mother. No economy can create these kinds of profits without having something special going on underneath. It's certainly not being driven by demand, with real consumption up just 2.2% annualized so far in this recovery.

Unfortunately, the improvement in profits has been hard to see or hear through all the noise and confusion coming from politics and overly pessimistic forecasters. We believe productivity statistics woefully underestimate "true" productivity growth because new technologies are hard to measure.

But, just because they are hard to measure, doesn't mean they aren't real. In fact, we expect them to accelerate in 2015. Part of the benefit of higher output and productivity is lower energy prices. We think oil prices will stabilize this year in the $55-70 per barrel range. While this will slow (but not stop) growth in the energy industry, it will free up resources to boost spending in other sectors of the economy – more smartphone and clothing sales will offset lower spending on gasoline.

We expect the Fed to start raising interest rates this year, even though the new voting members of the Fed are likely more on the dovish side. But rate hikes in the next year will only make the Fed "less loose" not tight. The federal funds rate will likely end 2015 near 1%, but would have to rise to 3.5% or above to be considered anywhere near "tight."

The new GOP-led Congress virtually guarantees that fiscal policy will stay on a more conservative course. In other words, big spending and debilitating regulation will remain on the sidelines. Yes, there is weakness in Europe (and potentially a socialist government in Greece), but the rising value of US currency signals more investment power for US corporations.

A strong dollar, along with rapid productivity growth, and a banking system that refuses to allow the money supply to surge along with Quantitative Easing, signals that inflation will remain subdued. We look for consumer prices, which rose less than 2% in 2014 to rise about 2.5% in 2015. This means that longer-term interest rates will likely rise as well and we expect the 10-year Treasury yield to rise to 3% by year-end.

Our stock market model (the Capitalized Profits Model) uses after-tax corporate profits discounted by the 10-year Treasury yield. Partly because profits have risen so strongly, but mostly because the 10-year Treasury yield is artificially low, this model still suggests that the S&P 500 is massively undervalued.

Using the fourth quarter average of the 10-year Treasury yield (2.28%), our models say the "fair value" of the S&P 500 is 4,465. But this number is artificial because the discount rate is being held down by Federal Reserve forward guidance. Using a 4% 10-year discount rate gives us a "fair value" calculation of 2,545 right now. So, if at the end of 2015, the 10-year Treasury yield were 4% and profits also rose by the average increase of recent years (around 10%), the market would be fairly valued at 2,800.

A year-ago, we forecast the S&P 500 would end 2014 at 2,150. We missed this target – it closed the year at 2,059 – but our bullishness was vindicated. The total return (including dividends) for the S&P 500 during 2014 was 13.7%, the third consecutive year of double-digit returns.

In 2015, we expect a fourth year of double digit returns and are forecasting a 15% increase in the S&P 500 to 2,375.

Surprises for 2015 could include an attempt by Greece to exit the Euro, which would end in disaster for Greek citizens but likely strengthen the dollar more. Also, the Supreme Court could undermine a great deal of Obamacare by striking down federal subsidies to those buying health insurance in many states.

In the midst of all this noise, we expect real GDP to grow 2.5%, another Plow Horse year, with a chance that growth will come in at a stronger 3%.

The bottom line is that while many analysts have turned more positive this year, finally agreeing with us, there is still a great deal of pessimism, fear and misunderstanding. The fear seems to be receding, but the economic and financial market punditry has mostly missed a world-changing surge in technology. They're not likely to miss it again in 2015. Optimism is finally catching on. Stay long.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-5 / *afternoon*	Total Car/Truck Sales – Nov	16.9 Mil	**16.9 Mil**		17.1 Mil
afternoon	Domestic Car/Truck Sales – Nov	13.7 Mil	**13.7 Mil**		13.8 Mil
1-6 / 9:00 am	Factory Orders – Nov	-0.4%	**-1.2%**		-0.7%
9:00 am	ISM Non Mfg Index – Dec	58.0	**58.5**		59.3
1-7 / 7:30 am	Int'l Trade Balance – Nov	-$42.0 Bil	**-$41.6**		-$43.4 Bil
1-8 / 7:30 am	Initial Claims – Jan 4	290K	**293K**		298K
2:00 pm	Consumer Credit– Nov	$15.0 Bil	**$15.8 Bil**		$13.2 Bil
1-9 / 7:30 am	Non-Farm Payrolls – Dec	240K	**202K**		321K
7:30 am	Private Payrolls – Dec	230K	**190K**		314K
7:30 am	Manufacturing Payrolls – Dec	15K	**12K**		28K
7:30 am	Unemployment Rate – Dec	5.7%	**5.8%**		5.8%
7:30 am	Average Hourly Earnings – Dec	0.2%	**0.2%**		0.4%
7:30 am	Average Weekly Hours – Dec	34.6	**34.6**		34.6